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LAW FIRM CONSULTANTS

WHAT'S HAPPENING OUT THERE?
THE STATE OF LEGAL MANAGEMENT IN 2005

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This is Smock Law Firm Consultants annual assessment of the state of the legal management marketplace. It covers the state of the market, trends, and what the winners will do.

OVERALL STATE OF THE LEGAL MANAGEMENT

If there were some official authorized to make a *"state of the legal industry"* address, similar to the U.S. President's State of the Union address, his/her prognosis would be quite positive.

- The legal industry is extremely healthy and experiencing annual returns to its owners more consistent and predictable than any stock exchange or index. In fact, the level of income enjoyed by good business law firm partners – on average – is growing at a consistently greater pace than who they are most often compared with – vice presidents at major corporations.

- The economy is providing good news to business law firms. Corporate profits are up and increasing, the merger and acquisition market is coming back (finally) in a very convincing manner, the jobs picture is very positive, and what has been a sluggish economic recovery is clearly picking up steam. Uncertainty still exists, primarily due to the threat of terrorism and volatile energy prices, but, on balance, the news is good.

- Business law firms prospered in 2004 (some with record breaking years, most with very good years) and absent external catastrophes (like damaging terrorist attacks), will likely do even better in 2005. The general rule has been that good business law firms do reasonably well when economic conditions are bad and do very, very well when economic conditions are good.

The legal market remains a growth industry – both domestically and internationally. Well diversified business law firms are fully expected to both grow and prosper (that is, in terms of partner income) in 2005 and beyond.

THE TRENDS – BOTH POSITIVE AND NEGATIVE

We see a number of positive law firm management trends.

The private practice of law has become a growing worldwide marketplace – even more than before. The Anglo-Saxon legal model has become the worldwide standard for business and commercial law, and the clear choice of global financial institutions. Not surprisingly, of the ten largest law firms in the world, six are US-based and four are UK-based. Nearly 100 US-based law firms have a presence in London and most of the major UK-based firms have presences in New York. Asian and South American offices – although often questionable relative to profitability – are appearing with increasing frequency.

Law firms are now acting and managing themselves like the businesses that they are. While vestiges of the *"town hall partnership"* management model remain, proven management techniques are replacing laissez-faire as the chief managing principle. Activities are measured, objectives are set, and accountability is considerably more fixed. The private practice of law is now more of a managed and coordinated team effort than the individual personal *"quest"* that it had historically been.

Most of the country's most successful major law firms are now being run by very effective leaders. For many years, law firm managing partners concerned themselves with day-to-day management of operations and administration, with the frequent inter-partner and personal issues thrown in. In recent times, more visionary leaders have been elected to law firm CEO positions and many are doing a remarkable job of reshaping their firms to capitalize on future opportunities. Because their compensation is more in line with the other owners of the business, they do not suffer from the same problems as many CEOs of major corporations do (e.g. – greed begetting greed). The very best of them recognize in their positions a true need to serve their firms as institutions and their fellow partners as owners and stewards of those institutions. We see very few greedy, self-absorbed, and arrogant law firm CEOs.

Strategic planning and – more importantly – strategic management, in response to an agreed upon strategic direction, has dramatically improved. Well-managed firms have a very clear understanding of their competitive position in their chosen markets and they understand how to protect and enhance strong competitive positions. Fewer and fewer firms are busy chasing fads or going head-to-head with market leaders who already occupy strong and defensible market positions.

Slowly but surely, law firm practice groups (especially industry teams and/or client-service teams) are becoming better and better, both professionally and as client-focused managed business units. Some years ago, large law firms came to the realization that they had become too large to be effectively managed as a single entity or as a town hall of individual partner entities. Having previously tried to divide into sections or departments and manage according to area of law, they realized that client-focused and industry-focused practice groups are strategically more effective, being externally rather than internally focused. Firms are learning (often through the necessary crucible of trial and error) how to do it well and consistently. With those who have succeeded, results have often been quite dramatic.

The really good firms are taking advantage of talented, cost-effective non-lawyer management. Major firms started creating Executive Director positions in earnest about twenty-five years ago. Since then, a strong COO has become the hallmark of a well-managed law firm. In recent times, moreover, we have seen a marked improvement in the quality of non-lawyer managers in the key functions of marketing, finance, human resources, technology, recruitment and knowledge management.

Law firm partners are behaving and functioning more as true owners of the enterprise and members of the team. Law firm partners, today, generally understand far more about the economics of law practice than their predecessors of only five or six years ago. Moreover, they are more adept at applying economics and *"business hygiene"* in the way they carry on their practices. Any large law firm will, of course, have its outliers, but teamwork, cooperation and partner engagement have become reinforced (and enforced and rewarded) values in many firms.

Law firm marketing is becoming more effective. Rather than allocate resources merely to those partners that ask for it, priorities are being set, practices are being directly supported, and the effectiveness of marketing initiatives is being evaluated. Marketing directors (or CMOs) are also better and serving critical management roles in their firms.

There is no need to worry about the accountants – they are not direct competitors. For a while, the mantra of some law firm consultants was that the major accounting firms were *"going to eat the lawyers' lunch"* competitively. While we believed then that this was a false fear, some in the profession were worried. That worry has gone away. Sarbanes-Oxley and the accountants' growing core business, in response to Sarbanes-Oxley, have kept and will keep the accountants focused on their own very profitable franchise.

We also see some less than positive trends – but the positive ones do clearly outweigh the negatives.

The market for legal services is becoming more and more competitive. As marketing gets better, firms can project differentiating expertise that can disrupt existing long term relationships. General counsel are putting up obstacles to both getting and expanding work – such as diversity considerations. Simply put, it is a lot tougher market for firms of all sizes.

Better firm management and business hygiene have produced very positive financial results, but the limit has been reached. Much of the significant law firms profit increases have come from managing the specific elements of profitability (chargeability, realization, leverage, and rates). Rate increases, particularly, account for a large portion of many firms' increased profits. But, the easy increases are over – continued per partner profit increases will have to come from clearly adding value to their clients' businesses.

Rising legal costs make alternatives more economically feasible. As attorneys' rates continue to go up, many clients start looking for alternative billing arrangements (e.g. – the GE electronic bid room) or alternative sources (e.g. – additional in-house attorneys, shifting work to non-major city firms, etc.).

***"Lone Rangers"* and *"unproductive partners"* are still management problems**. There may be fewer Lone Rangers than just a few years ago, but they are still out there – blindly assuming that the role of the firm is to enhance their personal practices, holding on to their clients for dear life, and creating the most significant malpractice risks at their firms. Unproductive partners are management's weeds – as soon as you deal with one, another crops up. In spite of the fact that most firms have dealt with the most egregious cases, unproductive partners are a cancer eating at the commitment of the younger, more productive partners (the future of any firm).

Underleveraged firms and practices may be the last generations. We see a number of business law firms where the partners outnumber the associates by factors of up to three to one. Also, even within well leveraged firms, we see practices where there may be six or seven partners and only one associate. Simply put, these firms and those practices are in their last generation of productivity – there is no one to take over client relationships and to continue to build the business. Without substantial seeding of people, they will wither and die.

There is still a good bit of *"fluff"* marketing out there. While we believe marketing effectiveness is dramatically improving, there is still an enormous amount of fluff marketing out there. There is a reluctance by many firms'/practices' partners to do the more painful (but most effective) marketing – solid research, active contacting, etc. Rather, marketing is still primarily promotional in nature, even at the practice level where promotion is arguably the least effective.

WHAT WILL THE WINNERS DO?

Reason tells us that this present-day law firm competitive environment will produce winners, survivors and losers, as it always has. Losers will merge out of existence or simply close their doors. Survivors will be around, but will not enjoy as great an economic up-side and will probably see defections of key partners and practices to other firms. Winners will, among other things, strengthen their hold on defensible strategic positions and enjoy a rate of profit growth well in excess of their competitors.

What will the winners do? We believe the most successful firms will:

- **Combine superior client services (true value), outstanding attorneys, effective management and creative marketing.** These are what we call *"the four pillars of law firm success."* If a firm can perform in all four areas, it will be very successful (professionally and financially).

- **Operate in response to an agreed upon vision (and the strategies to carry out that vision).** Simply put, winners will create and successfully implement a well-thought-out strategic plan.

- **Do *"different things differently."*** Non-conformity will trump conformity. We are not suggesting that firms should take uninformed or uncalculated risks. However, they should not feel bound to precedent or whatever the rest of the herd is doing. Innovation is the key to becoming and staying a winner.

- **Be truly responsive to clients.** Partners must invest time in talking with and – most importantly – listening to their clients (i.e. – conducting client interviews and converting knowledge gained into improved client service). Understanding and figuring out how to facilitate the client's business objectives are things winners work hard at and learn to do well.

- **Organize around specific market and client needs, not just legal specialties.** Functional groups are important for training and developing lawyers, and for ensuring quality control. They are a poor choice for strategy implementation and marketing. Think of functional groups as the source of skilled labor and market-focused groups as the delivery system for those skills.

- **Balance centralized management needs with the power of practice groups (and client service teams) and decentralization.** Today's law firms operating in multiple locations are too large and complex to be managed effectively as a single unit. Effective groups need to be close to the market and their key clients, and they need to be small enough to be nimble and responsive.

- **Put time, effort and resources behind effective practice/specialty group management.** It's a case of nurture over nature. Effective leadership and management come naturally to some, but most often they are acquired skills. Even "born leaders" can improve if one invests time, effort, and resources in training and supporting them.

- **Be well run in the short run – a lean, mean fighting machine.** One emphasis, here, is on *lean*. It implies efficiency and agility. The other emphasis is on *mean*. Rather than misanthropy, it implies courage and the will to get the job done for the client.

- **Figure out how to get away from *"the tyranny of the billable hour"* and charge closer to true value.** Winners who listen to their clients, understand their businesses and business objectives, and take time to study the market forces affecting their clients will have a better idea of what their services are worth to their clients and will charge accordingly.

- **Use strategic, tactical, marketing, and financial planning as the primary management tools at the firm, practice group, and location levels.**

- **Institute comprehensive practice group planning; reject the concept of individual partner plans.** Face it – the top of the food chain is inhabited by *"humans operating in groups."* Lone wolves are considerably lower on the food chain. Individual plans may be helpful in changing behavior or setting goals for use in compensation discussion. But, nature has proven that groups are stronger strategically than individuals – they should do the planning.

- **Reallocate marketing funding away from *"firm visibility"* efforts and into support for marketing practice groups and/or client-service teams.** By now, most firms are well-known enough in their communities and local markets that general awareness marketing (particularly comparing themselves to an animal of some sort) produces marginal returns that fall well below the cost of the effort. By allocating resources and attention to support targeted group efforts, the winners will achieve a much better return on their marketing investments.

- **Analyze the target markets of practice groups and structure groups accordingly; identify growth markets, stable markets, and mature markets and adapt group economics accordingly.** Winners understand that different markets produce different margins and require different economic success models. For example, a good return can be derived from a *"commodity"* practice, but only if it can be leveraged by staffing it with *"off-track"* associates and/or non-lawyer professionals.

- **Adapt partner compensation systems to measure and reward team/group successes, *"firm-first"* behavior, cross-marketing, development of others' skills and business-like practice management; make the compensation system support the strategic plan.** Winners will rid their firms of the *"cult of the individual"* and find innovative ways to measure and reward behaviors that support strategic plan implementation, rather than simply stressing personal statistics. If you do not measure desired results, you will not get them.

- **Seriously consider mergers and acquisitions as effective ways of achieving a stated direction; reject them if they do not.** Many well-managed firms already have developed profiles and templates that summarize the kinds of merger/acquisition targets that support their strategic plans. All opportunities are evaluated relative to the plan objectives. By applying the filter early in the analysis, they avoid spending time on fruitless and serendipitous opportunities. Winners will also find creative uses for strategic alliances with other firms, rather than outright merger or acquisition.

These are but a few of the things winning firms will do in the coming years to shape their own opportunities and manage for profitable results. We do not believe that *"business as usual"* and *"follow-the-fleet"* are successful strategies. To paraphrase Martin Luther, *"if they rest, they rust."* Successful law firms need to be alert to new opportunities, clever enough to spot good ones, and bold enough to take advantage of them quickly.

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Peter Giuliani , John Smock, and John Sterling are partners in Smock Law Firm Consultants, a strategy focused management consulting firm. We serve a wide range of leading law and other professional service firms in five key areas of practice – strategic planning, mergers and combinations, practice group management, and strategic management issues resolution (profitability improvement, compensation, partnership structures, governance, organization, etc.).

Additionally, we serve a number of well-known corporations in strategic planning and in addressing other strategic issues.